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SUBJECT: UNDERSTANDING RECENT INFLATION IN IRAQ

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¶1. (SBU) SUMMARY: The impact of the December 2005 fuel price increases contributed to a one month, one-time inflation spike of 13.1 percent in February 2006. Although inflation is undesirable, a one-time inflation increase based on a badly-needed economic reform (see reftels for similar situations in Jordan and Syria) is preferable to the current "built-in," perennial inflation of 30 percent that is driven by government spending. Reducing the current high level of inflation will require fiscal measures to control GOI spending, including additional subsidy reductions and decreased fuel imports. Classical monetary instruments for controlling inflation (such as lowering interest rates, decreasing the money supply, and marketing T-bonds) have been surprisingly ineffective in Iraq. END SUMMARY.

¶2. (SBU) The 13.1 percent monthly inflation increase in February 2006 was unusual not because of its size but because it occurred so early in the year. In both February 2004 and 2005, the economy cooled down after January, a month of high inflation as the impact of end-of-year government spending and private consumer spending was felt. For example, inflation rose 13 percent in January 2005 but then sank to negative .3 percent in February 2005. The same pattern occurred in 2004. After the large February 2006 inflation increase, March 2006 inflation was 1.7 percent. Inflation still is running high: it was 21.7 percent in the first quarter of 2006, already above the IMF's 2006 objective of 15 percent. Most disturbing is that the annual inflation rate from March 2005 to March 2006 was 53.4 percent.

Reform-driven Inflation

¶3. (SBU) In December 2005, the GOI began a first-ever round of IMF-required fuel subsidy reductions. Implementation of the reductions was uneven as a number of provinces resisted, but eventually most of the country went along and the price of regular gasoline increased 500 percent (5 cents to 25 cents). (NOTE: The GOI is scheduled to implement four fuel price increases this year, but nearly all of them are much smaller than the December 2005 increase. The GOI did not implement the increase planned for March 2006; however, key GOI officials have told us that they will consolidate the March increase into the June increase. END NOTE.) For reasons unrelated to inflation (problems with domestic refining and decreased fuel imports), fuel supply dropped precipitously in early 2006. Fuel shortages became more widespread, and Iraqis turned to buying fuel at higher black market prices. As a result, the two consumer price index categories most sensitive to fuel prices increased sharply in February: "transportation and communications" by 15 percent and "fuel and light" by 61 percent. This was a one-time

shock, however, since in March "transportation and communications" increased only 3.3 percent and "fuel and light" decreased 0.1 percent.

¶4. (SBU) The February 2006 inflation rate suggests that, for the first time, Iraq experienced reform-driven inflation as the gradual removal of subsidies pushed prices towards real or market prices. Other countries experienced similar challenges when beginning economic reforms, including Russia in the early 1990s. The difference in Iraq, however, is that a high inflation rate (over 30 percent annually since liberation) is already built into the economy. As a result, even higher levels of inflation may be expected if the government does not accompany subsidy reforms with measures to drive down government spending. The GOI is pursuing a mixed policy, however, by increasing government spending; plans for 2006 include a 67 percent government workforce expansion, a budgeted 150 percent increase in pension expenditures, and additional budget transfers to the provinces. Although these measures can soak up unemployment, they are inherently inflationary.

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Managing Inflation: Why Monetary Instruments Don't Work in Iraq
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¶5. (SBU) The GOI's challenge is that it lacks effective monetary instruments with which to fight inflation. Interest rates do not work because they are way below the rate of inflation (the current commercial lending rate is 12-15 percent, well below the current 53.4 percent annual inflation rate). The GOI has begun a market for treasury bills, but at this point the amounts bought and sold are too small either to expand or contract the money supply. Controlling the

money supply has not worked either: in 2005, inflation increased by 31.7 percent while the money supply contracted 6.1 percent, contradicting textbook economics that printing less money decreases inflation.

¶6. (SBU) The reality is that the Central Bank of Iraq (CBI) influences money supply but does not control it. The CBI estimates that about 60 percent of Iraq's money supply is currency (much in U.S. dollars) that is not saved in banks. Many Iraqis had bad experiences with banks under Saddam. In addition, the economy is heavily dollarized. Although the exact amount is unknown, some estimates approximate that 20 percent of the Iraqi economy is dollarized.

Exchange Rate Controls

¶7. (SBU) The one monetary tool that the CBI has used to limit inflation is pegging the Iraqi dinar closely to the U.S. dollar (at about 1475 dinars). In 2005, the dinar was devalued about 1 percent while the difference between U.S. rate of inflation (3.4 percent) and Iraqi inflation (31.6 percent) was 28.2 percent. This divergence suggests that in 2005 the dinar was overvalued by about 27 percent (the difference in the two inflations as well as the small dinar depreciation). One reason the CBI can sustain this is that it receives oil payments in dollars and can sell lots of dollars to soak up dinars. The problem is that, in the long-term, an overvalued dinar encourages imports and hurts Iraqis who produce for their domestic markets (keeping Iraqi non-oil exports expensive).

Comment

¶8. (SBU) Turning inflation around is a process of many inter-related steps -- mostly fiscal -- starting with

controlling government spending and lowering subsidies. The GOI needs to balance its budget but also has to spend its money on the right things, beginning with increased security, capital investments (particularly in oil), and planning for sustainment costs of U.S.-funded projects that will be turned over to the GOI. In the first quarter of 2006, the GOI's biggest budget expenditure was on salaries (including increased hiring and pay raises) and imported fuel. According to the Director General of Budgetary Affairs at the Ministry of Finance, nothing was spent on capital investments in the first quarter of 2006. At the same time, much work will need to be done by the next GOI to create a modern banking system that attracts cash and issues credit based on real interest rates (i.e., interest rates not lower than the rate of inflation). Even if the payoff for banking reform is less immediate, moving Iraq away from a cash-based, highly dollarized economy towards a credit-based economy (with banks that can extend home mortgages and make commercial loans according to market-based interest rates) will take time.
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